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IN THE

Supreme Court of the United States

OCTOBER TERM, 1976

No. 76-1203

C. ORVIS SOWERWINE, Trustee in Bankruptcy,
REA Express, Inc., *Appellant*

v.

UNITED STATES OF AMERICA, INTERSTATE COMMERCE COMMISSION, ALABAMA GREAT SOUTHERN RAILROAD COMPANY, ET AL., *Appellees*

APPELLANTS REPLY TO APPELLEES MOTIONS

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The Government's "analysis" of this Court's construction of Section 10 says it was not meant to cover "dealings between railroads and their subsidiaries" (p. 7). But Section 10 does not even address parent-subsidiary transactions; its sole concern as to carrier securities is with dealings by its managers, i.e., persons related to the issuing carrier as directors or officers. The appellees concede that if these related persons, eschew competitive bidding for a carrier's notes to give a preference to outside bankers represented by them, a

violation occurs. If on the other hand, the related persons cause the carrier to convert bookkeeping entries into interest bearing, long term notes to its owners, there is no violation. This Act of Congress, they tell us, does not prevent this kind of injury to a carriers' ability to serve the public if stockholders are not hurt; an odd policy to find in a public law.

Moreover, such a policy would contradict that espoused by the Commission in its official publications. As recently as February 5, 1977, the Commission made a report to Congress entitled Railroad Conglomerates and Other Corporate Structures, in which it pointed out the increase in "vulnerability to economic downturns" resulting from issuing fixed, interest bearing debt to carrier owners, instead of equity securities (p. 71). As far back as 1939, the Commission's Bureau of Statistics issued a Report entitled Railroad Sinking Funds and Funded Debt, in which it deplored the tendency of Class I railroads to use sinking funds for purposes other than the retirement of interest bearing capital debt. Conclusion No. 2, p. 106. Yet it is precisely such an abuse that the Commission now asks this Court to sanction.[1]

The Section 10 Court of Appeals cases cited by the Appellees held only that the issuing carrier must be injured by the securities manipulation (Klinger) and

[1] In a Staff Study entitled "Inadequacies of Protections for Investors in Penn Central and Other ICC-Regulated Companies," prepared for the Special Subcommittee on Investigations of the House Committee on Interstate and Foreign Commerce (92d Cong. 1971), the ICC's routine frustration of "the prophylactic purpose of Section 10" by "tacit endorsement" of carrier note issues is cited as "just one more example of that agency's complicity in frustrating the legislative purposes of the Acts under its jurisdictions." (p. 7).

that a transfer of assets by a parent to a wholly-owned subsidiary, does not, by itself, injure a carrier's ability to serve the public (Cleary).[2]

In the Section 20a(2) proceeding, where the Clayton Act violation had to be considered, the Government says there was no need to consider it because that violation had no "anti-competitive consequences," (p. 9). That act is apparently not the anti-trust law it says it is and ignoring its explicit competitive bidding requirements has no anti-competitive effect. Incredibly, this absured argument is found in a motion signed by members of the Justice Department's anti-trust division.

But more is at stake here than the proper construction of public laws. Where, as in the Commerce Act, Commission approval may immunize conduct against enforcement of other laws, it is especially important that the approval appear in a public decision that describes the immunized conduct; and that it be made on a public record. Both Statements in the appellee's motions are misleading in that neither discloses the ex

[2] In *Cleary* v. *Chalk* the assets there in question were exchanged for the entire amount of stock in subsidiaries to be owned wholly by the *same* common carrier. D. C. Transit merely changed the form of its ownership from assets to stock that remained entirely under its control. The transfers here involved, on the other hand, were upstream from REA to its railroad owners. Once paid out, REA could never get the money back. Thus the obvious difference from *Cleary* v. *Chalk* is that there, the equitable ownership of the assets remained with the common carrier whereas here, the assets were siphoned out of a carrier in the form of interest payments, to suit the predatory desires of its owners, who with their claims for the principal amount of the notes still seek to "crowd out" the other creditors in a contest for the limited remaining assets on liquidation. As the Court in *Cleary* v. *Chalk* recognized, the evil against which Section 10 of the Clayton Act was designed to protect "is financial imposition upon the carrier" (488 F.2d at 1324).

parte misrepresentation underlying their contention that Commission approval of the railroads creation of debt to themselves on REA's books, immunized them from any claim that creditors were thereby defrauded. As REA's expert witness, Eichner, pointed out, the railroad lawyers' private assurance to Director of Finance Mahaffie that their handling of REA's sinking fund would not affect its rates, proved wrong. (126a-128a). In the actual event, the interest on the railroads' "advances" increased REA's operating expenses by more than forty-three million dollars during the period 1929-70 (128a).[3]

Contrary to the railroad appellees Statement (p. 3), the Commission was not advised by them prior to its approval of their 1929 SEOA that they intended to treat sinking fund payments as advances from their respective shares of REA's net revenue. The Commission's order of approval was entered on February 11, 1929. 150 I.C.C. 423. The approved agreement provided for deduction of the sinking fund payments before any distribution of REA's income to the railroads. It said nothing about treating these payments as railroad advances and the REA Board's resolution authorizing such treatment was not adopted until two months later, on April 11, 1929.

The railroads' statement in footnote 2, page 3, that "the Commission had advance knowledge that such a step would be taken prior to its decision" is untrue. The citation to the opinion below (25a) does not support this statement. All the three-judge court said is that the 1975 Commission's Report "recounts the gen-

[3] Eichner's reference at 126a to his attachment 15, is to a copy of RR, Ex. 12, reproduced in full as the appendix to this reply.

esis of the non-negotiable debt and the Commission's knowledge of this change in 1929 and through later proceedings" (25a). The only specific conclusion of the Commission cited by the Court, was that the 1929 Commission "was adequately advised of *the possibility* of alternate methods of accounting for the sinking fund" (87a). Emphasis ours.

The evidence offered by the railroads to the Commission to support that conclusion was R.R. Ex. 12, a memorandum of the conference between railroad lawyers and Director of Finance Mahaffie on Jan. 11, 1929. After giving the assurance as to no rate effect, referred to by Eichner, the railroads' lawyers told Mahaffie that the REA semi-annual sinking fund installments "were simply capital investments by the (owning) carriers, and the carriers would be entitled to a return on them, whether they paid for them all at once or semi-annually." Parenthesis ours (4a).[4] In 1975 the Commission could find this statement to be adequate notice of the April 1929 reversal of the sinking fund practice stated in the agreement approved in February 1929 only because the statement was ambiguous as to what the owning carriers might do.

The 1975 Commission has thus condoned an especially subersive form of ex parte conduct. According to its opinion, telling the Director of Finance what railroads may do in equivocal terms at on off-the-record meeting is "adequate" notice to the Commission of what they later did.

Yet sound regulatory policy obviously required that the way in which REA's stockholders proposed to

[4] This refers to page 4 of the appendix to this Reply.

transform its public capital debt into private debt to themselves should have been brought to the attention of the Commission itself, in a formal proceeding requiring it to consider and decide where the public interest lay upon a public record. If the Courts are unwilling to hold regulatory commissions to a higher standard of conduct than that exhibited here, there is no hope for decent administrative control of business practices.

Finally, the creditor fraud issue was squarely raised below by REA's Rule 9(g) response to the summary judgment motion.[5] That response posed as a critical issue of fact, not subject to summary resolution, REA's claim that its railroad owners knew it was insolvent when they issued the notes to themselves and that the notes were issued without consideration. The alleged 1959 insolvency was specifically attributed to unrecorded liabilities on liquidation that included the unfunded pension claims noted at Page 10 of our Statement.

The suggestion in the railroads' motion (p. 18) that this creditor fraud issue was correctly resolved against REA by the Commission's finding of no fraud on the Commission is plainly wrong. Whether there was, as

[5] The railroad's Statement (p. 8) is in error in suggesting that the Trustee has not appealed from the summary judgment on the creditor fraud claim. The issue of fraud on creditors is one over which the ICC has no special competence, cf. *Nader* v. *Allegheny Airlines, Inc.*, 426 U.S. 290 (1976), or even jurisdiction. It is well established that dismissal of a plaintiff's antitrust claim should not result in foreclosure of such pendent state claims before trial. Cf. *REA Express, Inc.* v. *Travelers Insurance Co.*, No. 76-1450, United States Court of Appeals for the District of Columbia Circuit, April 21, 1977, where creditors claims were preserved although a summary antitrust judgment was affirmed.

a matter of law, a fraud on REA's creditors depends on an issue of fact not yet litigated; *i.e.*, were the unrecorded liabilities, plus the notes and the other liabilities appearing on REA's books, large enough to make REA insolvent in 1959.[6]

Neither the Commission nor the three-Judge Court even considered the evidence that would be needed to resolve this issue at a trial. Indeed, the only evidence in the record on that issue was not received in a form that would satisfy due process. The Commission's administrative procedure and the three-Judge Court's review of the Commission's conclusions was focused on the statutory policy found in the Clayton Act and the Commerce Act. New York State's statutes and common law governing debtor-creditor relationships were neither argued below nor considered in the opinions below.

Our brief discussion of the creditor fraud issue (pp. 18-21) was only to show that a substantial injustice would be done to creditors if the summary judgment below were affirmed. We did not bring the case here for a final resolution of the creditor fraud issue, there being no evidentiary record which could justify such a decision. This case is here because Section 10 of the Clayton Act deserves more explication by this Court than a footnote in a 1959 decision and because this Court has never even considered, much less discussed, the way in which the Commission should integrate Section 10's policy as to carrier security issues

[6] Based upon a report of April 15, 1959 made by Booz, Allen, & Hamilton to the railroads' representatives on REA's Board, contingent termination liabilities exceeded REA's assets by millions of dollars (REA Ex. 62, which appears in full at pages 82-91 of the Joint Appendix on which the case was heard below).

with the public policy expressed in Section 20a(2) of its own statute.

The perfunctory response, belatedly offered by the United States, displaying no thought as to the history or purpose of these laws, has emphasized the urgent need for this Court's review. Instead of a repeal by the Congress, these two beneficent federal laws have been repealed in practical effect by persistent and deliberate bureaucratic non-enforcement. The Government's mindless echo of the railroads' arguments is itself clear that plenary consideration is needed to induce the public's lawyers to give this Court the thoughtful and impartial assistance that it should have.

Respectfully submitted,

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APPENDIX

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Memorandum of Conference With Mr. Mahaffie, Director of Finance, January 11, 1929 — 9:00 A. M. Messrs. Nicodemus and Bell.

1. Jurisdiction of Commission

Mr. Mahaffie stated that he had already expressed his views on the Commission's jurisdiction, namely, when we were in Washington on December 5 before Division 4. I explained to him that since that conference we had considered the matter and reached the conclusion set forth in our memorandum. He said that he had some doubt on the subject, but that the Commission in other matters where the parties interested had come before the Commission asking them to take jurisdiction had been inclined to take jurisdiction. I got the impression that we would have no real difficulty on this point.

The Hearing Set For January 24:

(a) It will not be a proposed report case. It will be a full Commission case. It has been assigned to Commissioner Campbell, but Mahaffie probably will be the man who has to do most of the work. Unless something develops at the hearing which will require it, it will not be necessary to file briefs.

(b) *Intervenors' objections:*

Mr. Mahaffie said he had nothing further from National Industrial Traffic League, and that he had heard of no other objections to the Plan. I stated to him what Walter had written to me as to the N. I. T. L. objections, namely, that it did not wish the Express Company to become a merchandising organization, and they wished also to safeguard the matter of rates; and I stated that these objections were, of course, not contrary to anything that the

Express Agency was contemplating in these applications.

(c) *Testimony:*

I outlined our plan for having Mr. Storey make a complete statement of the express business, the nature and the purpose of the plan, and confining our testimony to matters of a general nature. This will be satisfactory to Mr. Mahaffie. We discussed the substantiation of the price to be paid for the real estate, and I told him how the appraisals had been verified by the carriers, and he seemed to take no exception to this method. We stated we would file a statement of the total appraisals, but, after discussion, said that we preferred not to put the details in the record. He himself suggested that it might lead to taxation on the values paid. As set forth below, he will expect a justification of the price at which the debentures are proposed to be sold, if it is on more than a 5% basis. We told him we would have Mr. Lutz, of the Express Company, present to supply any information desired, and that we would be prepared to cover fully any kind of objections to the Plan.

We also outlined the conditions upon which the Williams roads had come in, and told him of the agreement to put into the record Counsel's ruling upon the sinking fund provision.

3. Contract With A. R. E.:

We acquainted Mr. Mahaffie with the present status of the A. R. E. contract, and told him of the necessity for prompt action by the Commission, which I think he appreciates, and will undoubtedly do his best to forward.

4. Financing

We outlined the conferences with Messrs. Anderson and Hanauer, told him of their recommendations with reference to making the debenture issue a 20-year obligation, maturing semi-annually, like an equipment trust. We advised him of the difficulty in the sale of such security, because of its unavailability for savings banks, and the question as to whether it is an insurance investment; also mentioning the fact that the Express Agency will not under its contract be able to build up a reserve fund which will be security for the bonds. Mr. Nicodemus described Mr. Storey's conference with the bankers on the 7th instant, and said that, tentatively, they had suggested that the bond bear a 5% coupon, be offered to the public at par, and sold to the bankers at 97½. Mahaffie stated that, if the money was going to cost the Express Company more than 5%, he would have to have some showing made as to the price. It will be agreeable to have this showing made at the hearing on the 24th, if a definite price is agreed on at that time, subject to the approval of the Commission. Mahaffie also stated that the Commission would not act upon the Finance Docket Application until the details had been supplied. We told him the Trust Indenture is now in process of preparation.

5. Interlocking Directorates:

The Commission will not act on a blanket application. It will be necessary to have the individual applications filed in the usual course.

6. General

Mr. Mahaffie raised other questions which he said were in his mind:

(a) The validity of the applications under paragraph (2) of Section 5. The question he had in mind is

whether these applications filed by the Agents are a compliance with Paragraph (2) of Section 5, which requires such applications to be filed by carriers.

(b) The other question was as to the sinking fund provisions of the financing plan, and he inquired whether the requirement that the carriers pay off the bonds semi-annually would have any effect on the Express Agency's rates. We told him none whatever. He said he was not a rate man, but did not wish to have anything in this proceeding that would afford a claim that it should have been looked at from a rate standpoint. We told him that these semi-annual installments were simply capital investments by the carriers, and the carriers would be entitled to a return on them, whether they paid for them all at once or semi-annually.

M. L. B.

1/12/29.